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THE FEDERAL REVENUES AND THE INCOME TAX.

I.

For upwards of a decade, America, in the amplitude of her expanding wealth, has presented to the world of finance and administration the unique and almost isolated spectacle of a nation with revenues so redundant as almost to defy exhaustion or expenditure; of successive administrations whose efforts were employed, not in devising means by which taxes could be collected with the least possible friction and inequality, but rather in the spending of almost unwelcome revenues in order that their collection might be continued; of a party in power to whom the taxing machinery was an engine to be employed primarily for the support of an industrial policy, rather than for satisfying the legitimate demands of the State, and by whom protection was a fetish to be worshiped even to the exclusion of exact justice or scientific principles in taxation.

With the advent of the current fiscal year, however, the fruition of this prodigal policy became manifest in a proximate deficiency in the treasury. Not only had the appropriations of the two preceding Congresses imposed upon the government expenditure most extravagant, but an unforeseen commercial depression further embarrassed the administration by causing a marked reduction in the estimated receipts, traceable to the diminished consumption of taxable commodities. For upwards of a month the treasury has been confronted with a deficiency. Expenditures have not been diminished; in fact, for the quarter ending September 30, they exceeded those for the corresponding period of 1892 by three million dollars, while the customs and internal revenue receipts for the same months show a falling off of upwards of twenty million dollars, the difference amounting not

infrequently to as much as two millions a week. Assuming the present diminution to continue throughout the year, the revenues for the fiscal year 1894 will be smaller by over seventy-five millions than those of 1893, and, as compared with the treasury estimates made in 1892 for the same period, the loss will be considerably over one hundred millions.

Although this deficiency may be viewed as but temporary and traceable to the existing suspension of trade and general stagnation of industry, which a revival of business may be depended upon to rectify, still it is advisable to take precaution for a contingency, especially in view of the hostility on the part of Congress to every proposal looking to even a temporary loan. Moreover it is impossible to calculate with any degree of exactitude on the duration of the present depression and its effect upon the revenues, for our experience during the period subsequent to the crisis of 1873 shows that a depression may make its influence manifest in the revenues for years after the stringency itself has passed away.

Moreover, the party but recently called into power avowedly contemplates a complete reorganization of existing fiscal arrangements by such a modification of the customs revenue as, in the words of Adam Smith, will "occasion the least possible loss of money and enjoyment to the contributors, and the least possible impediment to the progress of national industry and wealth." Just how the fulfillment of these pledges will affect the revenues it is impossible to estimate. It may, in fact, operate to increase receipts, for our experience immediately subsequent to the war shows that an increase of rates is not always the best means of increasing the revenues of the State, but that on the contrary this result is frequently attained even more surely by a reduction of the taxes, especially those which bear upon consumption. By diminishing the charges which enter into cost is often to give to consumption a new and vigorous impulse.

English experience displays this apparent paradox even more strikingly than does our own. In 1842, when Robert Peel, by one of those transcendent strokes of genius which characterized his public life, undertook the reform of the revenue system, the budget had shown for several years a deficit. From 1837 to 1842 the expenditures exceeded the receipts by nearly forty million dollars. The trouble had become chronic and the remedy applied had been to advance the rates, with the uniform result that the revenues diminished rather than increased. Subsequent to the reforms of Peel, however, which were looked upon as chimerical in the extreme, and after the immediate reaction of the first few years, the revenues began to rebound, and from that time down to the later modifications in the revenues, manifested a steady and continuous increase.

The same results may possibly follow the reforms contemplated by the Democratic party, but for some years, at least until the country accommodates itself to the changes in the rates, a deficit is to be expected. This deficiency will approximate one hundred millions, possibly more, and will render necessary recourse to supplementary sources of revenue. The only alternative therefore is a return in part to the extraordinary system of internal taxation which obtained during and immediately subsequent to the Civil War. And such being the case, the question to be solved is—Does the best fiscal policy advise the opening up of new sources, such as the income, license, corporation, stamp or general excise taxes, or shall the revenues be increased by advancing rates upon existing taxable subjects? Our own experience proves and financial theory supports the principle, that, other things being equal, the best financial policy is that which interferes as little as possible with the greatest liberty of industry and the largest possible freedom on the part of the individual. Under peace conditions the general excise tax, such as existed during the war would not be endured, inasmuch as it contravened almost every principle

of taxation ; the stamp tax is objectionable for like reasons, while the license taxes now occupy prominent positions in nearly all the State systems. A return to the taxation of corporations, especially those of an inter-State character, which as a rule are inadequately taxed by our States, owing to constitutional and judicial restrictions, has much to commend it, but the practical difficulties in the way of the passage of such a tax render it improbable that it will be seriously considered. Several proposals have been made recently looking to the rehabilitation of the income tax, and such a measure would have strong support in the Western States. This tax has much to defend it, and theoretically it appears to be the most equitable of taxes. The burdens which it imposes are palpable and likely to induce a more careful scrutiny into public affairs ; it is ascertainable in amount and is not hidden from the view of the payor by entering into cost ; it is not cumulative, does not interfere with business relations and does not impinge upon the limit of subsistence of those possessing but small incomes, as do the customs and excise taxes. Thus it satisfies most thoroughly that canon of taxation which prescribes equality of sacrifice on the part of citizens. Many of these excellencies are corroborated by our own experience during the war, but despite this fact, as well as the approval which it has received from the hands of economists and financiers, it has never been other than unpopular with American people, and the opposition and antagonism which every suggestion looking to its restoration as a portion of the federal system has aroused, leads to the belief that in the memory of the people its administration was accompanied with so many inequalities and annoyances that an attempt to replace it would be an error. In the following pages we shall endeavor to indicate the operations of this tax during the period extending from the outbreak of the war down to 1872, when it was repealed, and then to deduce from these experiences some conclusions

as to its propriety as a federal measure and also its applicability to the present circumstances.

II.

The first reference to the income tax in American annals is to be found in the special report of Secretary Dallas in 1815, in which he advocates the imposition of the income duty, along with many others, as temporary war duties for the support of the treasury during the continuation of hostilities. No attention seems to have been paid to this suggestion, however, and it does not appear that any attempt was made from this time down to the outbreak of the Civil War to derive revenue from internal sources. Even at this latter time it is a matter of some surprise, in view of the general hostility of the American people to any tax which savors of inquisitorialness, that Congress should have had recourse to the income tax at the extra session called during the summer of 1861, when it imposed the direct or apportioned State tax,* and before any attempt had been made to open up those sources of indirect taxation which had formed the bases of the earlier excise systems of Hamilton and Gallatin. Possibly this may be explained in part by the prevalent belief in the early suppression of the rebellion, and by the desire on the part of Congress and the administration to devise a system which would be but temporary, immediately productive, and would not interfere with industry. The duties imposed by the measure were not, however, onerous. Thus all incomes not exceeding \$800 were declared non-taxable, while incomes in excess of that amount were made taxable at the uniform rate of three per cent. Incomes derived from public securities, however, paid but one and one-half per cent, unless held by citizens resident abroad, when five per cent was deducted. The tax was self assessed upon schedules prepared for the purpose, and was to be based upon receipts for the preceding year irrespective of their source.

* Act of August 5, 1861.

In case of neglect to comply the assessor was directed to estimate the income himself from the best information obtainable, and to add thereto a penalty for non-compliance with the law. The administration of the tax was placed in the hands of the internal revenue officials, for which the bill made authorization. Each State comprised a revenue district, in each of which a principal assessor and collector were appointed, with plenary authority further to subdivide their districts as they might see fit ; while at the head of the system stood the Commissioner of Taxes, later denominated the Commissioner of Internal Revenue.

In addition to the minimum exemption mentioned above a further deduction was permitted the payor for any expenditure for State or local taxation, for rent and the customary repairs.

This measure had not yet become operative when Congress, reassembling in regular session, introduced modifications which rendered its previous action inoperative. By the measure adopted early in 1862 the exemption was reduced to \$600, and the rates were made slightly progressional, while the administration was rendered very cumbersome and inquisitorial by requiring the most minute return of all sales made or stock of goods on hand.* The result of these provisions was, in the eyes of the Commissioner of Internal Revenue, sufficient to deprive the tax "of all claims to public favor," although he was impelled to acknowledge that the "people have accepted it with cheerfulness to meet a temporary emergency."† In order that it might not appear too inquisitorial, however, and thus prove needlessly offensive to the public, he instructed the officials that returns of incomes should not be open to inspection by others than the proper officers of the revenue, and further recommended to the

* Act of July 1, 1862. The rates imposed by this measure were as follows : Upon incomes below \$10,000 and above \$600 the rate was three per cent, while incomes above the former amount were assessable at five per cent.

† Report on Finances, 1863, p. 70.

consideration of Congress the advisability of making the rates more rapidly progressional, so that the tax would bear with greater severity upon large incomes.* The method of assessment was vexatious in the extreme, for instead of its being based upon some criterion of revenue, such as rental value, as the Commissioner later advocated, † the law required the assessor to secure from each taxable an itemized account of the sources of his income for the previous year. For instance, if he be a farmer, the value of all "incomes or gains derived from the purchase and sale of stock or other property, real or personal, and the increased value of live-stock, whether sold or on hand, and the amount of sugar, wool, butter, cheese, pork, beef, mutton or other meat, hay and grain, or other vegetables or other produce."

With such methods of administration as these it occasions no surprise that the tax was unpopular, the returns incomplete, and the burdens unequally distributed. There is no reason apparent why he who consumed his produce should be exempted from giving returns, while he who saved it should be taxed; neither is it apparent why he who lived in his own house should not be permitted to make deductions for its rental value the same as if he had rented the house from another and paid the rental from his pocket. Yet such were some of the anomalies of the law.

Later modifications eliminated many of these inconsistencies and corrected the more radical defects of the law, but the comparatively moderate returns secured, even while the tax was supported by the war enthusiasm of the people, prove conclusively the futility of assessing a tax upon such elusive bases.

The duties imposed under this law remained in force but two years, when by the comprehensive law of June 30, 1864, ‡

* *Ibid.*

† *Ibid.*, 1864, p. 65.

‡ One week subsequent to this most comprehensive measure Congress by joint resolution imposed a special income tax of five per cent upon all incomes exceeding \$600, which was to be collected in addition to the regular income tax. It was assessed but once (in 1865), the war closing early in that year, and produced \$29,381,862.

they were again increased and rendered more gradually progressive. By this latter measure incomes between \$600 and \$5,000 were taxed at the rate of five per cent ; those from \$5,000 to \$10,000 at seven and one-half per cent ; and all incomes above the latter amount at the uniform rate of ten per cent. The administration being rendered somewhat complicated by this classification, a later law reduced the classes again to two, and incomes over \$5,000 were rendered dutiable at the uniform rate of ten per cent.*

The war closed almost immediately after and the imperative necessities of the treasury were in part relieved. Measures for the immediate repeal of the income tax were at once proposed, but Congress wisely chose first to relieve those objects most oppressed by the excise. Industry was shackled and the laws of trade set at variance by the duplication which the internal taxes imposed. The income tax fell mainly upon accumulation, and in the opinion of the special Revenue Commission, appointed in that year to devise methods for the reform of the system, would "probably be sustained with less detriment to the country than any other form of taxation—the excise upon spirituous and fermented liquors and tobacco possibly excepted.† It is this impotency of the income tax to affect prices and industry, as well as its non-interference with the free employment of capital, which renders it such a fit emergency tax and commended it to Pitt during the Napoleonic wars and to Peel during the reorganization of the British financial administration in 1842. It is in addition elastic and capable of immediate and indefinite expansion in time of temporary necessity. For this reason it served as a fiscal bridge upon which the finances of the country might be supported until industry and trade could accommodate themselves to the changed conditions of production immediately subsequent to the close of the war.

* Act of March 3, 1865.

† Report of Revenue Commission, House Ex. Doc., No. 34, Thirty-ninth Congress, p. 27.

Unfortunately the report of the Revenue Commission, so complete and satisfactory in other respects, offers but little information in regard to the operations of the income tax. Its retention was, however, advocated, but with some important modifications. To the Commission the progressive element was an unjust discrimination, since it was a "tax upon the results of successful industry and business enterprise." It therefore recommended the repeal of this discrimination and the imposition of a uniform rate of five per cent on all incomes over \$1,000, an exemption which was held to be equivalent to \$600 at the time when the tax was first imposed, inasmuch as the inflation of prices had greatly enhanced the cost of living. The report further recommended that no deductions for house rent be permitted, or if such be allowed that they be limited to \$300, inasmuch as it had been found that such excessive rentals had been permitted by the assessors, that in New York alone the losses to the revenue from this source had exceeded two millions of dollars per annum.*

Congress conceded to this report in so far as it related to the increase of the exemption to \$1,000, with a uniform rate of five per cent upon incomes above that amount, but the proviso was attached that the measure should expire by limitation in 1870.† This latter provision was not observed, however, for Congress, fearing that the revenues would prove inadequate, later extended its operation two years longer, but with the rate reduced to two and one-half per cent and the exemption increased to \$2,000.‡ It is curious to note that under the latter arrangement the tax became even more unpopular than it had been at the time of its greatest extension, for it assumed in the eyes of the payor the form of a compulsory tribute imposed upon accumulated wealth and was hence deemed unjust. The productivity of the tax further suffered

* Report of Revenue Commission, House Ex. Doc., No. 34, Thirty-ninth Congress, p. 28.

† Act of March 2, 1867.

‡ Act of July 14, 1870.

from the fact that in addition to the above exemption, as well as all taxes, both State and local, deductions were permitted for all losses "actually sustained by fires, floods, ship-wrecks, or that occurred in trade ; amount of interest paid during the year, the amount paid for rent or labor to cultivate land," as well as any expenditure incurred in repairs.

The effect of these provisions was to render the tax almost inoperative and scarcely worthy of retention. Thus the taxables returned in 1871 were but 74,775, while in the following year (the last of the operation of the tax) the number further fell off to 72,949 ; while the receipts for the same years were respectively \$14,434,949 and \$8,416,685.

Few taxes were more unpopular or odious to the people than the income tax. From its first imposition it was assailed as invading the sanctity of the most private affairs, as being inseparable from inquisitorial scrutiny into business relations, and an insufferable penetration into those affairs of the individual which were in a sense sacred, and which in the past had been exempted from the visits of the excise man. It was further alleged, with some truth, that a tax which offered such opportunities for evasion was a charge upon honesty and a premium upon false returns. In the large cities especially was the tax exposed to widespread evasion and fraud. In the hands of an honest and conscientious official the mode of assessment was vexatious in the extreme, while in the hands of an incompetent one it was open to all sorts of collusion. In the former case it was grievous, annoying and unpopular ; in the latter unjust, tempting to evasion and falsehood, and destructive of the moral sense of the people, who came to view the oath lightly and to look with equanimity upon any attempt to defraud the revenue.

In a country like our own, where but little stability exists in business relations ; where speculation in some form or other is a great, one might almost say chief, source of wealth ; where large revenues from landed property are rare, and where incomes vary from year to year almost as widely

as among different individuals, and where none of that stability of commercial relations exists which is characteristic of Great Britain, and renders a uniform rate of taxation of but little practical injustice; when to this is added the difference in our ideas of civic integrity, it is a cause of no surprise that the income tax was unpopular, unjust, and subject to such abuses as almost to render it untenable as a Federal measure.

Moreover, the American people are a sensitive, "touchy" people. The doctrine of *laissez faire* is carried to extravagant lengths with us, and any tax whose collection requires official penetration into private affairs is by that very fact a bad tax. Our practical, utilitarian philosophy holds that tax to be the best tax which is best administered and follows the lines of least resistance, or whose collection is embodied in the sententious aphorism of the French, "*l'art de plumer la poule sans la faire crier*," a proverb which possesses the large grain of truth that from the standpoint of public morals a bad law well executed is better than the best law feebly executed. Moreover, such complete confidence was reposed in the individual that evasion of the tax was an easy matter, and the instruction of the Commissioner early in 1863 only facilitated it. Later legislation, however, threw all returns open to the public, and the Commissioner instructed officials to have them published in the pages of local papers, "in order," as he said, "that the amplest opportunity may be given for the detection of any fraudulent returns that may have been made."* The efficiency of such a ruling in compassing the object desired may be questioned, for it seems to have induced a hostility to the tax which probably offset any stimulus to honest returns through the fear of detection.†

In order to facilitate the collection of the tax extensive use was made of a system of stoppage at the source. By

* Boutwell's "Direct and Excise Taxation in the United States," p. 259.

† See *The Nation*, November 25, 1869.

this means corporations of a certain kind announcing dividends shaved off the tax and paid it to the collector before the distribution of the dividends to the stockholder. In this way a large portion of the tax was paid without the income passing through the hands of the eventual payor of the duty, while fraudulent returns were rendered impossible and the necessity of supervision reduced to a minimum. It has been estimated that the cost of returning this portion of the tax did not exceed one-fifth of one per cent, a fact which led the Commissioner to recommend that this method be extended to all corporations declaring profits upon dividends.* The greater efficiency of this system as compared with the collection through individuals will be seen from the fact that in 1865, when the total receipts were \$32,050,017, nearly forty per cent was covered into the treasury through the instrumentality of the banks, canal, railroad, insurance companies and Federal employees.†

But despite the fact that the income tax was despoiled by fraud and evasion, it proved one of the most satisfactory, from a purely fiscal point of view, of the many expedients hit upon by Congress in its omnivorous search for objects for taxation. Thus in 1865 it produced as much as was received from spirits, both malt and distilled, and tobacco; while in the year following it returned nearly forty per cent more than these combined sources. In the former year over fifteen per cent of the entire internal revenue receipts were derived from this source; in 1866 over twenty per cent, and in 1867 over twenty-four and one-half per cent.

As indicative of the general distribution of wealth and the variations of income, it is interesting to note the receipts from the various classes of payors from 1863 to 1867, at which latter date the new provisions went into effect.

* Report on Finances, 1863, p. 73.

† The tax upon incomes from Federal office-holders was collected by the disbursing officers, who were directed to withhold the tax from all salaries of United States officials.—Boutwell's "Direct and Excise System in the United States," p. 260.

These receipts were as follows :

	* From incomes over \$600 and not over \$10,000.	* Over \$10,000.	From property of citizens resident abroad.	From interest on U. S. securities.	† Over \$600 and not over \$5,000.	† Over \$5,000.
1863	\$172,770	\$277,461	\$1,872	\$3,637		
1864	7,944,153	6,855,160	58,674	75,373		
1865	9,697,246	9,362,339	169,924	133,402	\$539,143	\$801,971
1866					26,046,759	34,501,122
1867					31,492,694	25,547,946

* Rates at three per cent and five per cent.

† Rates at five per cent and ten per cent.

It will be noticed that the increased rates imposed by the law of 1864 did not make themselves felt in the receipts until two years after their imposition, an indication of the comparative slowness with which the excise became operative. It is also of interest that the receipts at three and five per cent, provided by the law of 1862, bore nearly the same relation to each other as did the receipts under the latter act of 1864. Moreover, this same parity is observable when we examine the returns of taxables. Thus in 1866 the Commissioner reported that from 185 of the 240 collection districts the assessors received returns from 190,189 taxables, acknowledging incomes over \$600 and under \$1,000; from 162,513 having incomes over the latter amount and under \$5,000; while 31,009 persons made acknowledgment of annual revenues in excess of the latter sum.

Presuming this ratio of returns to hold good for the entire country, the number of taxables returned for the year 1866 could not have been over 500,000 at the outside, from which we must conclude, approximating the population at forty

million souls and estimating one taxable for every five persons, that either but one taxable in every sixteen received an income over \$600, or else that the tax was but poorly collected. The latter alternative is in all probability the correct one, although even the former indicates a comparatively high standard of life.

As corroborative of the former opinion, as well as indicative of the sectional inequality of the tax, it may be cited that in one collection district in New York the receipts from the income tax for the fiscal year 1867 were \$5,496,233, while the entire tax collected during the same period from the eleven States of Virginia, Texas, Tennessee, South Carolina, North Carolina, Mississippi, Louisiana, Alabama, Georgia, Arkansas and Florida was less than one-half that amount.* As further indicative of the territorial distribution of the burdens of taxation, it may be cited that, in 1869, Massachusetts, New York, New Jersey, Pennsylvania, Ohio, Illinois and California, although possessing but forty per cent of the total wealth and population of the country, paid upwards of three-fourths of the entire income tax collected.

In the years immediately subsequent to the Act of March 2, 1867, which increased the exemption allowed on incomes to \$1000, the number of taxables returned manifested a considerable falling off, while the receipts were diminished by about one-half. This measure was limited in its operation to four years, during which time the average number of taxables returned was 267,210, of which number nearly sixty per cent paid taxes of over twenty dollars. The receipts during these years were as follows :

Year.	Receipts from Individuals.	Receipts from Salaries of U. S. Officials.
1867	\$27,418,000	\$1,029,992
1868	23,390,000	1,043,561
1869	27,353,000	561,963
1870	26,150,000	1,019,526

* The collections on account of the income tax for the fiscal year 1867 from these States were as follows : From Florida, \$14,197 ; Arkansas, \$34,980 ; Mississippi, \$60,740 ; South Carolina, \$62,208 ; North Carolina, \$62,450 ; Virginia, \$204,623 ; Texas, \$155,340 ; Tennessee, \$396,327 ; Louisiana, \$586,282 ; Georgia, \$320,552 ; Alabama, \$404,036 ; total, \$2,300,931.

As a closing enactment to the long series of experimentation on the income tax the limit of exemption was increased in 1870 to \$2,000, with the avowed intention of relieving all save large incomes from the operations of the tax. The rate of taxation was further reduced to two and one-half per cent, at which point it remained until 1872, when the tax expired by limitation. During these latter years the receipts from this source were scarcely worthy of collection, while the fact that the law had been inspired by Western legislators anxious to shift the burdens of the excise upon the rich capitalistic class of the Eastern manufacturing states, gave it in the eyes of the latter class the form of an enforced contribution, which they felt justified in evading. No assessments were made after 1872, in which year the last collection was made.

While the experience recounted above may seem to be sufficient to destroy any claim of the tax to favor, it is still impossible to draw from it wholly adverse conclusions as to its suitableness as a Federal expedient, inasmuch as the defects were not intrinsic ones, but were mainly administrative, traceable in a large measure to the spoils system of patronage which dictated the distribution of appointments. The entire system, as the Special Revenue Commission at the close of the war indicated,* was vitiated and rendered so inefficient from this cause that had the measure been never so perfect and never so well suited to our political and economic conditions, it would of necessity have broken down. Imperfect as this experience is, however, it inclines to the conviction that the income tax to be efficient must be confined to smaller areas. The wide expanse of territory, the lack of homogeneity in racial and economic conditions, as well as the considerable burdens imposed by the State and municipal units render it inadvisable for the Federal power to depend in times of peace upon direct taxation in any form. The

* Report of Revenue Commission, House Executive Doc. No. 34, Thirty-ninth Congress, First Session, pp. 17.

assumption by the Federal power of the principal forms of indirect taxation renders it necessary for the local units to depend in large measure upon land and incomes for meeting their growing expenditures, and while the income tax, as now understood, is not wholly suited for State or local purposes, it is still better adapted to their use than to the nation at large.*

III.

In view of this experience, therefore, it would seem inadvisable at the present time to recur to the income tax as a means for tiding over or meeting the contemplated deficiency in the revenues. An alternative is to be found in the increase of the rates upon whisky, malt liquors and tobacco, subjects which already constitute the principal and most productive objects of internal taxation.

At the present time these commodities are objects of revenue in some form or other in nearly every civilized State; in some through governmental manufacture and sale, in others as a basis of taxation. Aside from the fact that they are articles usually held to be superfluous, and by many harmful luxuries, these objects find favor in the eyes of financiers from the fact that the demand for them is to a large degree what Professor Marshall terms "inelastic." Consumption, it is held, does not follow price as it does in other commodities, for experience has shown that the demand remains about the same, no matter what the cost of production.† In other articles a substitute usually presents itself

* Professor Bastable dissents from this view, and holds that the difficulty of localizing incomes renders this tax wholly unsuited for local taxation, even though it be applied to the American States or the Swiss cantons. See "Public Finance," p. 360.

† Such at least is the customary theory in regard to such articles, but our own experience does not wholly corroborate it. Thus, during the years extending from 1864 to 1868, when the exorbitant war rates obtained upon these articles, the number of cigars and gallons of whisky returned for taxation fell off very markedly, although much of this was traceable to evasion of the tax. Moreover, during the six years subsequent to the crisis of 1873, the consumption either fell off or failed to increase proportionately with the growth of population, a phenomenon which has been repeated during the past few months. It is also to be taken into consideration that

which more or less completely satisfies the want, while not infrequently the increase in price effectually checks the consumption. Not so with the articles under consideration, for as yet no substitute has been found for intoxicants or narcotics. The equation of demand and supply for such commodities is therefore not a parabola, but a straight line, and the only problem which confronts the financier is an administrative one—namely, the character and amount of duty which from a fiscal point of view will prove the most efficient.

Our own experience in seeking a solution to this problem forms one of the most interesting chapters in recent fiscal history. First chosen as an object of revenue by Hamilton in 1791 as the basis of the permanent excise system which he contemplated organizing, the tax upon spirits was from the first odious and unpopular to the people, and formed, according to the opinion of Hildreth, one of the chief causes of the later downfall of the Federalist party. Ten years later (in 1801), upon the advent of Jefferson and the Democratic party to power, the tentative efforts of Hamilton were swept away, and not until bankruptcy stared the government in the face under the pressing exigencies engendered by the war of 1812, was the tax again imposed. From this time down to the outbreak of the Civil War no recourse to any form of internal taxation seems to have been contemplated by any party, and the manufacture and sale of distilled spirits came to be one of the most important industries of the American people; the output of the country in 1860, as estimated by the census of that year, exceeding 90,000,000 gallons, a fact which commended it to Congress as a fit object of revenue. Along with tobacco and malt liquors, therefore, distilled spirits were among the first objects hit upon by Congress in its search for objects of revenue, and while the rates

a reduction of the amount of whisky returned does not always indicate a reduction in domestic consumption, for the article is so susceptible of adulteration that any increase in price almost inevitably leads to a deterioration in quality. Roughly speaking, however, these articles, unlike most luxuries, may be said to be inelastic and not subject to change in demand with every alteration in price.

imposed under the early laws were inconsiderable, they soon formed fruitful sources of revenue.

The first tax upon distilled spirits was but twenty cents per gallon (or 100 per cent *ad valorem*),* a rate ridiculously low in comparison with those imposed by foreign States, and early in 1864 † the tax was increased to sixty cents, at which point it remained until July of the same year, when it was further advanced to \$1.50 a gallon, ‡ and later to \$2.00 per gallon. § The result of this continued experimentation was to induce speculation on a wide scale. In anticipation of the increase in the tax distillers forced production to the uttermost in order to take advantage of the increase in the price, for the tax was not made applicable to stock on hand or in bond. Distilleries sprang up in great numbers, induced by the unusual profits to be made from the manufacture of spirits, and the stills which, according to the census of 1860, numbered but 1,138, increased in three years to 2,415, which number was again nearly doubled by 1868.

Enormous fortunes accrued to the producers from this anticipation of the duty, inasmuch as when the product was placed upon the market the tax was added to the cost, just as if it had been paid. These profits for the period of two and one-half years, extending from July 1, 1862, to January 1, 1865, making every allowance for overestimate, could not have been less than \$100,000,000, a sum which, had the increased rates been made immediately operative, would have accrued to the treasury at a time when it was suffering under every form of embarrassment.

The same phenomena which characterized Congressional action in regard to whisky distinguished its efforts to derive a revenue from tobacco. Like distilled spirits, the rates imposed upon this subject by the comprehensive measure of 1862 were soon recognized as insufficient, and Congress, to

* Act of July 1, 1862.

† Act of March 7, 1864.

‡ Act of June 30, 1864.

§ Act of December 22, 1864.

whom nothing seemed more axiomatic than that "two and two make four," even in the arithmetic of taxation, at once proceeded to treble the rates, with the same result that followed in the case of whisky. It has been carefully estimated that the losses to the revenue from the anticipation of the tax upon tobacco equaled those of distilled spirits, while the further diminution in the receipts from these sources, due to evasion and dishonest collusion with officials, almost surpasses comprehension. Not only was the machinery of administration untrained and inefficient, but the rates of taxation were so high as to induce fraudulent returns wherever possible. Dishonesty and evasion were well-nigh universal. In fact, the experience of the four years extending from 1864 to 1868 is sufficient to establish the principle that a system of taxation, to be efficient, must not impose rates so high that the ordinary penalties are insufficient to deter men from attempting to evade them, for whenever this occurs and the profits to be derived from illicit production form a stronger incentive to cupidity than the penalties do as preventives, then the government overreaches itself and places a premium upon crime and fraud.

Since 1868, in which year the rates upon distilled spirits were reduced to fifty cents per gallon,* while those upon cigars and tobacco were reduced fifty per cent, our experience has been more fortunate. Frauds were soon reduced to a minimum and have since practically ceased; while the revenues have steadily increased in conformity with the growing wealth and population of the country. Thus the receipts from tobacco rose like magic from \$18,700,000 in 1868, to over \$31,000,000 in 1870, under the reduced rate; while from distilled spirits the revenues increased from \$14,500,000 in 1868, to over \$45,000,000 in 1869, a sum which in the following year further advanced to \$55,000,000.

During the intervening years the duties upon these objects have been subject to frequent change. Upon whisky the

* Act of July 20, 1868.

rate was raised from fifty to seventy cents in 1872,* at which figure it remained for three years when it was again advanced to ninety cents per gallon,† where it has remained unchanged ever since.

Rates upon tobacco on the other hand have been successively lowered in conformity with the demand for "free tobacco, the poor man's luxury," and at the pressure of those interests hostile to any reduction of the tariff. In 1883 the rates upon all forms of domestic tobacco as well as special license taxes were reduced fifty per cent, or to three dollars per 1,000 upon cigars and to eight cents a pound upon manufactured tobacco,‡ while in 1890 all the special license taxes for the sale of tobacco were abolished and the rate upon manufactured tobacco still further reduced to six cents a pound.§

Just what effect has followed this reduction of the tax upon the price of tobacco and whisky it is difficult to determine with any degree of accuracy. There is reason to believe, however, that it has been but slight, if any. The price of drinks sold over the bar has remained the same whether the duty was two dollars or fifty cents per gallon, although the quality of the article sold may have improved. In the case of cigars and tobacco the same is true, although many contend that even this advantage has been lost to the public and accrues to the manufacturer through the formation of the tobacco trust.

The tax upon malt liquors has remained practically unchanged from the first imposition of the tax by the act of July 1, 1862. By this measure the duty was placed at one dollar per barrel of thirty-one gallons, which is equivalent to an ad valorem tax of twenty per cent, or approximately one-fifth of a cent per glass. Inasmuch as the article can be produced at an average cost of from one and two-thirds to

* Act of June 6, 1872.

† Act of March 3, 1875.

‡ Act of March 3, 1883.

§ Act of October 1, 1890.

one and three-quarter cents per glass, and sells at retail for five cents, this is manifestly an insufficient rate as measured by what other commodities entering largely into consumption are taxed.

From these combined sources, whisky, tobacco and malt liquors, it is believed that revenues almost unlimited may be obtained. Of well-nigh universal consumption, as these articles are, socially harmful in their effects and unnecessary to the comfort and well being of the nation, the payment of the taxes may be viewed as wholly voluntary, as a sum abstracted from the surplus fund of individual income.

The objection is not infrequently brought against these taxes that, although theoretically duties upon luxuries, they are in reality burdens imposed upon the laboring classes, inasmuch as they form the largest body of consumers of liquors and tobacco, and it is this class whom it should be the first aim of the government to protect. By continued use they have become a necessity to the majority of the people, and the want is of such an "intense" order that it is often satisfied, even if to the exclusion of those more essential to comfort.

The force of this objection rests largely upon the theory that all taxes upon commodities are eventually shifted to the consumer; that any addition to the cost of production in the form of a tax is forthwith added to price, and is thus diffused throughout the community. In substance this argument is as follows: The manufacturer who pays the tax in the first instance, will not deduct the same from his profits, for in a system of free competition profits are already at a minimum. He therefore views it as one of the essential increments to cost of production, and forthwith adds it to price, with a further profit added thereto for the advancement of his capital. Otherwise he would cease producing. He cannot recoup himself from labor nor from the farmer who produces the raw product. In a like manner the same process goes on in the retail transaction, until the enhanced cost is

eventually taken from the final payor who consumes the finished product.

But this theory is only true under conditions of perfect competition, conditions which, unfortunately, do not exist in the manufacture and sale of the articles under consideration, for the production and sale of whiskey, malt liquors and tobacco, is in a measure subject to the laws of monopolistic value. Now manifestly, the principle of diffusion recognized to be true under free competition is inoperative here, inasmuch as free and perfect competition is not to be found. Profits are therefore not regulated by the mean average profits secured in other industries, for monopoly price is always fixed at the point where the largest sales and the largest gross profits will be realized. The substantial truth of this contention is to be seen from an examination of the effect of the changes of rate upon prices, for during the war, when the extraordinary rates obtained, the prices for drinks sold over the bar remained the same, whether the tax was two dollars or fifty cents a gallon. Our recent experience in regard to tobacco further substantiates this theory, for the price of cigars has remained practically the same, whether the rates were six or three dollars per 1,000, while the duty upon chewing or smoking tobacco, which is uniform whatever the retail price of the article, has varied but slightly with the duties at thirty-two, sixteen, or six cents per pound.

A partial shifting of the tax does take place by adulteration and the use of inferior grades of tobacco, but competition is so imperfect that the public has but little security against such practices, even at the present time. Moreover, that unusual profits are to be made from the business of retail liquor or tobacco selling, is seen from the fact that a large family can be supported from the income of a comparatively insignificant establishment, while the recent exhibition of the whisky and brewing trusts indicates that exceptionally large profits are obtainable from these industries.

Within recent years the businesses of distilling, brewing and tobacco manufacture, have been consolidated into comparatively few hands, so that the price as well as the grade of these articles is capable of being fixed arbitrarily and without reference to those elements which are usually determinate factors.

It is such considerations as these, therefore, which lead to the belief that the taxes upon these articles, unlike other commodities of universal consumption, are in part at least extracted from monopolistic profits, and do not greatly, or at least wholly, enter into the price and bear upon the consumer.

They are, moreover, in no sense obstructive to industrial freedom and there is no evidence that even the highest rate imposed has ever proven productive of any very general discontent. It is such considerations as these that renders these subjects favorite ones for taxation, for it is the practice of nearly every European government to derive from these sources the largest possible income consistent with efficiency of administration and the highest social welfare.

Few will contend that this point has been reached in the United States, certainly not in regard to tobacco and malt liquors. As regards distilled spirits however, Mr. David A. Wells maintains that the rate is as high as that subject will bear and supports this contention by reference to our humiliating experience during the years extending from 1864 to 1868, when the two-dollar rate obtained.* But it must be remembered that the conditions of administration as well as production have changed materially since that time. No longer is the revenue service raw and untrained. Officials have become familiar with the laws, alterations in the rates are made but infrequently and means for the prevention and detection of fraud have greatly improved. Moreover, the organization and successful conduct of the so-called "whisky trust" has placed in the employ of the government a most

* Special letter to Secretary of Treasury, July 8, 1893, p. 13.

effective agency for the prevention of illicit distillation, for it is manifestly to the interest of this combination to prevent rather than encourage the evasion of the tax, while the eventual result of this concentration of the business into a few hands will be to localize production and render the collection of the tax a comparatively easy matter. At the present time the area of illicit distillation is confined within the mountainous districts of the South, where the output is comparatively unimportant and does not enter into the general market. It is therefore believed that the rate upon distilled spirits could be increased to \$1.25 per gallon without material loss in quantity consumed, while the revenues would be increased thereby thirty million dollars. It is even believed that the rate could be still further advanced with advantage to the revenue, but the social effects consequent upon adulteration in the retail trade render such a course of doubtful expediency.

An equal amount could be obtained from an increase in the rate upon malt liquors from \$1.00 to \$2.00 per barrel. As a popular beverage the consumption of beer is increasing at a phenomenal rate, the quantity taxed per capita nearly doubling during the thirteen years subsequent to 1880.*

Since 1863, when the duty was first imposed, the amount returned for taxation has increased from 62 million gallons to 1071 millions, or an increase in the per capita consumption of from 1.86 gallons to over sixteen gallons. During the same period the revenues have increased at a like rate from \$1,558,000 to \$32,000,000, or a per capita increase of revenue of from five to forty-eight cents. Moreover, unlike distilled spirits, illicit manufacture is so difficult, owing to the fact that large and expensive plants are essential to production, that an increase in the duty is not likely to lead to a repetition of the same disastrous results that characterized the taxation of distilled spirits. With an increase of the tax to \$2.00 per barrel, or forty per cent ad valorem, the consumption

* In 1880 the consumption was 8.25 gallons per capita; in 1893, 16.02.

would not materially suffer, nor would the quality of the article, while an increase in the revenues of thirty-two millions could be expected.

A like sum could also be secured with comparative ease from a doubling of the rates upon cigars and tobacco, which are taxed at a lower rate in this country than in almost any other. The receipts from this source in 1893 were but \$32,000,000; by doubling the tax the revenues could be increased to \$64,000,000, while with an increase in the rate equal to that now in force in Great Britain the receipts could be augmented to eighty-five million dollars, while were the same rates imposed as are collected in France, this sum would be swollen to one hundred and twelve million.*

With these alterations made the revenues from these three internal sources might be increased from \$159,000,000 to \$253,000,000 as follows :

	Receipts 1893.	Estimated Receipts.
Distilled spirits	\$95,000,000	\$125,000,000
Fermented liquors	32,000,000	64,000,000
Tobacco	32,000,000	64,000,000
Total	<u>\$159,000,000</u>	<u>\$253,000,000</u>

With such a balance-sheet as this and with such unparalleled showing of resources no apprehension need be felt for even the most radical alterations in existing revenue arrangements, for it is safe to assert that contemporary history can make no other such exhibit of unemployed powers and unopened resources.

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* These statistics, as well as the estimates, are taken from the special letter of Hon. David A. Wells to the Secretary of the Treasury, July 8, 1893.